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Construction and Surety Law

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CONSTRUCTION AND SURETY LAW

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I. INTRODUCTION

DURING late 2002 and throughout 2003, the developments in construction and surety law focused on a wide variety of substantive issues, most notably including decisions regarding general construction disputes, substantial completion, mechanic's liens, retainage and trust fund claims, performance bond disputes, claims for liability for subcontractor's employees, sovereign immunity, waiver of implied warranties, and the enforceability of arbitration clauses. The Texas Supreme Court remained quite active in the construction arena, issuing some important decisions on subjects including waiver of implied warranties, arbi-

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tration agreements and awards, and lien rights and retainage requirements. The Texas Courts of Appeals issued a particularly large number of decisions which directly impact the construction and surety practitioner. A number of those decisions are discussed here. Very notably, the various courts of appeals had the opportunity to apply the rules set forth in several of the Supreme Court decisions discussed in the last two years' articles.

II. IMPLIED WARRANTY ISSUES IN CONSTRUCTION

In December 2002, the Texas Supreme Court issued its decision permitting the waiver of the implied warranty of habitability and implied warranty of good and workmanlike construction in *Centex Homes v. Buecher*.[1] In that case, the Texas Supreme Court determined that both implied warranties can be waived under the proper circumstances, although only the implied warranty of good workmanship was effectively waived under the facts of the particular case.[2] The opinion overruled the holding of the San Antonio Court of Appeals, which is discussed in detail below.

In *Buecher v. Centex Homes*,[3] decided by the San Antonio Court of Appeals in March 2000, the court held that a home builder would not be permitted to require a purchaser to sign what the court described as a "contract of adhesion," which waived the implied warranty of habitability and good and workmanlike construction in the context of new home construction.[4] In its holding, the court supported the continued viability of *Melody Home Mfg. Co. v. Barnes*.[5] The court's reasoning was that it would be incongruous if public policy required the existence of the implied warranties, yet permitted the waiver or disclaimer of the warranties in the form of a pre-printed statement form disclaimer in a standard form contract.[6] The court rejected the builder's argument that *Melody Home* prohibits the waiver of implied warranties only in the context of the repair of tangible personal property.[7]

The homeowner argued that the waiver provision violated Section 17.46(b)(12) of the DTPA. Centex argued that the waiver was permissible because the homeowners would be adequately protected by the Residential Construction Liability Act. It also argued "that the waiver of implied warranties should be permitted because the express warranties provided in lieu of the implied warranties serve the 'gap filler' function

1. Centex Homes v. Buecher, 95 S.W.3d 266 (Tex. 2002).
2. *Id.* at 268.
3. Buecher v. Centex Homes, 18 S.W.3d 807 (Tex. App.—San Antonio 2000, pet. granted).
4. *Id.* at 810-11.
5. Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349 (Tex. 1997) (holding that the implied warranty to perform repair services in a good and workmanlike manner cannot be waived).
6. *Buecher*, 18 S.W.3d at 808.
7. *Id.*

which the implied warranties are designed to satisfy."[8]

The San Antonio Court rejected Centex's arguments, citing the Texas Supreme Court's adoption of implied warranty law relating to new home construction from 1968,[9] as well as the law of *Melody Homes.* Based upon those authorities, the San Antonio Court concluded that the reasoning expressed in those cases applied equally to new home construction.[10]

On appeal, the Texas Supreme Court stated that it agreed with the San Antonio Court of Appeals that the implied warranty of habitability cannot be waived, except under limited circumstances not implicated in the particular case before it.[11] The court disagreed with the court of appeals' conclusion that the implied warranty of good and workmanlike construction cannot be disclaimed, holding instead that when the parties' agreement sufficiently describes the manner, performance, or quality of construction, the express agreement may supercede the implied warranty of good workmanship.[12]

In the case before the supreme court, Michael Buecher and other homeowners purchased new homes built by Centex Homes or Centex Real Estate Corporation. Each homeowner signed a form sale agreement prepared by Centex, which contained the following disclaimer:

> At closing Seller will deliver to purchaser, Seller's standard form of homeowner's Limited Home Warranty against defects in workmanship and materials, a copy of which is available to Purchaser. PURCHASER AGREES TO ACCEPT SAID HOMEOWNER'S WARRANTY AT CLOSING IN LIEU OF ALL OTHER WARRANTIES, WHATSOEVER, WHETHER EXPRESSED OR IMPLIED BY LAW, AND INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF GOOD WORKMANLIKE CONSTRUCTION AND HABITABILITY. PURCHASER ACKNOWLEDGES AND AGREES THAT SELLER IS RELYING ON THIS WAIVER AND WOULD NOT SELL THE PROPERTY TO PURCHASER WITHOUT THIS WAIVER.[13]

Following the purchase of their homes, Buecher and others sued Centex for fraud, misrepresentation, negligence, and violations of the Texas Deceptive Trade Practices Act.

The Texas Supreme Court began its analysis of the question of whether and when implied warranties can be waived with a review of its decision in *Humber v. Morton*,[14] where the court originally recognized that a builder of new homes impliedly warrants that the residence is constructed in a good and workmanlike manner and is suitable for human habita-

8. *Id.* at 810.
9. *Id.* at 811 (citing Humber v. Morton, 426 S.W.2d 554 (Tex. 1968)).
10. *Id.*
11. Centex Homes v. Buecher, 95 S.W.3d 266, 268 (Tex. 2002).
12. *Id.*
13. *Id.*
14. Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

tion.[15] The court recalled that in imposing the warranties, which superceded the concept of *caveat emptor*, it recognized both the significance of the purchase of a new home for most buyers, as well as the difficulty in discovering or guarding against latent defects in construction.[16]

Next, the court discussed the development of the doctrines in its *G-W-L, Inc. v. Robichaux*[17] opinion, where it established the rule that the "*Humber* warranty" could be disclaimed or waived if that intent was clearly expressed in the parties' agreement.[18]

Finally, the court addressed the impact of *Melody Home Manufacturing Co. v. Barnes*[19] on the implied warranties. In *Melody Home*, the supreme court recognized the implied warranty of good workmanship in the repair or modification of tangible goods or property, and further held that, as a matter of public policy, the implied warranty for repair services could not be waived or disclaimed.[20] The court's discussion in that case noted the incongruity of requiring the creation of an implied warranty, but permitting its waiver by a pre-printed, standard form, suggesting that such disclaimers should not be allowed because they encouraged shoddy workmanship.[21] At the conclusion of that opinion, the Texas Supreme Court purported to overrule *Robichaux* "to the extent that it conflicts with this opinion."[22]

In the *Buecher* opinion, the supreme court noted that the meaning and scope of the court's prior statement regarding overruling *Robichaux* was ambiguous because it is not clear to what extent *Robichaux* and *Melody Home* actually conflict, since they address different subject matters and different implied warranties.[23] Because the holding of *Melody Home* had cast some doubt regarding the validity of the *Robichaux* opinion, the supreme court re-visited its analysis in *Robichaux*.

In the context of the *Robichaux* case, which addressed an alleged defective roof on a new home, the trial court rendered judgment for the buyers, based upon a jury finding that the builder failed to construct the roof in a good workmanlike manner, and that the home was not merchantable at the time of completion. The supreme court reversed and rendered judgment for the builder, holding that the implied "warranty of merchantability" was a sales warranty under the UCC, which did not apply to a house.[24] Further, the court determined that there were, based upon the language in the sales documents, no warranties, express or implied, of any kind, and that the written documents were sufficiently clear

15. *Id.* at 555.
16. *Centex Homes*, 95 S.W.3d at 269.
17. G-W-L, Inc. v. Robichaux, 643 S.W.2d 392 (Tex. 1982).
18. *Id.* at 393.
19. Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349 (Tex. 1987).
20. *Id.* at 354-55.
21. *Id.*
22. *Id.*
23. Centex Homes v. Buecher, 95 S.W.3d 266 (Tex. 2002).
24. G-W-L, Inc. v. Robichaux, 643 S.W.2d 392, 394 (Tex. 1982).

to disclaim any implied warranty of habitability.[25] The court's opinion did not distinguish between the separate warranties of habitability and good workmanship, however. The analysis did not discuss any of the public policy considerations for the implied warranty of habitability either.

In *Buecher*, Centex Homes argued that the court should adhere to the *Robichaux* holding, because it was consistent with the decisions from other states allowing the disclaimer of implied warranties, which arise in the context of a sale of a new home. The supreme court noted, after reviewing the various states' opinions, that the cases either ignored the implied warranty of habitability or treated it as part of the implied warranty of good workmanship.[26] The court found that point important, since Texas does recognize the implied warranty of good workmanship and the implied warranty of habitability as separate warranties.

The supreme court concluded that the implied warranty of good workmanship focuses on the builder's conduct, while the implied warranty of habitability focuses on the state of the completed structure.[27] The implied warranty of good workmanship recognizes that a home builder must perform with at least a minimal standard of care, and requires the builder to construct a home in the same manner as would a generally proficient builder engaged in similar work under similar circumstances.[28] The court noted that the implied warranty of good workmanship is a "gap-filler" or "default warranty" and applies unless and until the parties express a contrary intention.[29]

In contrast, the implied warranty of habitability looks at the finished product and is more limited in scope, protecting the buyer from those defects that undermine the basis of the bargain.[30] In essence, it requires the builder to provide a home that is safe, sanitary, and fit for human habitation, and it protects the buyer from conditions that are so defective that the property would be unsuitable for its intended use as a home.[31]

The court noted that the two warranties do parallel one another and may overlap in certain circumstances, since a builder's inferior workmanship may render a home unsafe.[32] It also noted carefully the reason for the separate existence of the warranties and the public policy underlying the implied warranty of habitability. The court emphasized that the *Humber* warranties were originally created in order to protect the average homebuyer who lacks the expertise to discover latent construction defects. In defining the way it would ultimately separate the warranties, the court concluded that while "the parties are free to define for them-

25. *Id.* at 393.
26. *Centex Homes*, 95 S.W.3d at 272.
27. *Id.* at 272-73.
28. *Id.* at 273.
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*

selves the quality of workmanship, there is generally no substitute for habitability."[33]

Therefore, the court held that the warranty of habitability is an essential part of a new home sale and that the warranty of habitability can be waived only to the extent that defects are adequately disclosed to the buyer.[34] The court's example of where the waiver might apply was in the context of a sale of a problem home, where the buyer had express and full knowledge of defects that might affect its habitability. The court's ultimate conclusion was that the implied warranty of habitability, which extends to latent defects only, cannot be disclaimed generally, but does not apply to known defects, even substantial ones, which are disclosed to the buyer.[35]

In contrast, the court found that the implied warranty of good workmanship defines the level of performance expected when the parties do not expressly define that standard in their contract, and functions as a "gap-filler" in that respect.[36] As a result of that analysis, the court found that the parties can have an agreement which supersedes the "gap-filler" or implied warranty, but cannot simply disclaim it.[37] Therefore, the implied warranty of good workmanship may be impacted or overridden when the "agreement provides for the manner, performance, or quality of the desired construction."[38]

III. SOVEREIGN IMMUNITY

The issue of sovereign immunity, and the application of the various administrative proceedings which have been created by statute, were discussed by various courts of appeals during 2003 against the backdrop of recent Texas Supreme Court opinions on such topics. Those opinions continued to apply general rules regarding the "no waiver by conduct" concept, but one significant opinion also demonstrated that exceptions do exist.

The most significant cases from 2001 and 2002 set the stage for the decisions during the past year. The 2001 opinion in *General Services Commission v. Little-Tex Insulation Co.*[39] focused first on the issue of waiver by conduct, specifically the argument by contractors that the state waived immunity by merely accepting the benefits of the contract. In that case, the court concluded that under the new scheme set forth in Chapter 2260 of the Government Code, "a party simply cannot sue the State for breach of contract absent legislative consent under Chapter 107. Compliance with Chapter 2260, therefore, is a necessary step before a party can

33. *Id.* at 274.
34. *Id.*
35. *Id.* at 274-75.
36. *Id.* at 274.
37. *Id.*
38. *Id.* at 275.
39. Gen. Servs. Comm'n v. Little-Tex Insulation Co., 39 S.W.3d 591 (Tex. 2001).

petition to sue the State."[40]

The Texas Supreme Court adopted a consistent approach in 2002 in *Texas Natural Resource Conservation Commission v. IT-Davy*.[41] The issue presented in the case was whether IT-Davy, a general contractor, could sue the Texas Natural Resource Conservation Commission ("TNRCC"), a state agency, for breach of contract, where IT-Davy argued that it had fully performed under its contract, but the TNRCC did not fully pay for services it accepted. The supreme court concluded that merely accepting the benefits of a contract is not sufficient to establish waiver.[42] In its conclusion, the court noted again its "one route to the courthouse" rule and emphasis on legislative consent.[43] However, the concurring opinion by Justice Hecht contains perhaps the most significant analysis, and perhaps a hint about the future direction of the analysis of sovereign immunity. The concurrence stated that it agreed with the ultimate holding of the court, but disagreed with the broad language used by Justice Baker in the majority opinion. Justice Hecht noted that he doubted "whether governmental immunity from suit for breach of contract can be applied so rigidly," but declined to decide any broader issues not presented by the facts of the case, as follows:[44]

> In his opinion for the Court in *Federal Sign v. Texas Southern University*, Justice Baker noted that there may be "circumstances where the State may waive its immunity by conduct other than simply executing a contract so that it is not always immune from suit when it contracts." In his opinion today, he appears to have abandoned this view, stating that "allowing . . . governmental entities to waive immunity by conduct that includes accepting benefits under a contract would be fundamentally inconsistent with our established jurisprudence." He does not explain this about-face. The Court was correct in *Federal Sign*. As one example, it has long been held that the State can waive immunity by filing suit. There may be others, such as debt obligations. We need not here decide the issue for all time, any more than we needed to in *Federal Sign*.[45]

A. Waiver Through Filing Suit

A key exception to the waiver of sovereign immunity doctrine was the basis of a recent Austin Court of Appeals case which was argued in late 2003 and decided in January 2004. In that case, the court held that the State does waive sovereign immunity when the State, as plaintiff, files a case in district court, and the defendant in the case files a compulsory

40. *Id.* at 598.
41. Tex. Natural Res. Conservation Comm'n v. IT-Davy, 74 S.W.3d 849 (Tex. 2002).
42. *Id.* at 857.
43. *Id.* at 860.
44. *Id.*
45. *Id.* at 860-61 (Owen, C.J., Hecht, J., Phillips, J. Jefferson, J. concurring) (internal citations omitted).

counterclaim.[46] The facts of the case involved a Texas Department of Transportation ("TxDOT") project, where the original contractor, Sedona, was terminated by TxDOT. The surety, Fidelity and Deposit Company ("F&D"), completed the project, after receiving demand by TxDOT to complete under the performance bond. At the completion of the project, TxDOT sued F&D, seeking to recover additional costs on the project which TxDOT claimed that it had incurred. F&D counterclaimed for breach of the same contract which was the subject of TxDOT's claims to recover damages it incurred during its performance under the contract and bond.

The trial court denied the State's plea to the jurisdiction, finding that the State had waived sovereign immunity, and specifically immunity from suit, by filing the case in the district court. By its actions, the trial court held that the State subjected itself to the filing of counterclaims which were related to or germane to the State's original claims. In analyzing the issue, the Austin Court of Appeals specifically noted that a well-accepted exception to the sovereign immunity doctrine is waiver by filing suit where the state is the plaintiff in a case filed in district court. The court's language on this issue was clear and forceful:

> We acknowledge and reaffirm that it is the legislature's sole province to waive or abrogate sovereign immmunity. But just as Texas courts have adhered to this general rule for over a century, they have also recognized an exception to this rule—when the State initiates suit. It is well established that the State's initiation of suit is an exception to sovereign immunity from suit clearly recognized by Texas courts.[47]

The Austin Court of Appeals also specifically referred to the concurring opinion by Justice Hecht in the *IT Davy* case discussed above in reaching its holding. Further, the court rejected the State's arguments that the State sued F&D as a surety, but F&D counterclaimed as a completing contractor. The Court held that the arguments were unpersuasive and that the claims and counterclaims related to additional expenses and costs incurred by the various parties in connection with the construction project.[48]

Finally, the Austin Court held that the administrative process, under Section 201.112 of the Transportation Code, which the State tried to impose upon F&D, was not a proper administrative procedure, because, by statute, the procedure was limited in its application to highway projects. Because the project in question was a building, not a highway, which is defined to include "a public road or part of a public road and a bridge, culvert, or other necessary structure related to a public road,"[49] Section 201.112 did not apply. As a result, the court concluded that F&D had no

46. State v. Fid. & Deposit Co. of Md., 127 S.W.3d 339 (Tex. App.—Austin 2004, no pet. h.).

47. *Id.* at 343.

48. *Id.* at 344-45.

49. TEX. TRANSP. CODE ANN. § 221.001 (Vernon 1999).

administrative remedy to exhaust.[50]

B. No Waiver Through the "Sue and Be Sued" Language

In *Satterfield & Pontikes Construction, Inc. v. Irving Independent School District*,[51] the Dallas Court of Appeals addressed the issue of sovereign immunity in the context of a local school district. The Irving School District contracted with Satterfield for the construction of a new middle school. During construction, the project encountered various delays in completion. At the end of the project, the contractor sued the school district for additional compensation for the project and for an extension of the completion time.

The contractor argued that the school district waived sovereign immunity, particularly the immunity from suit, by the terms of Section 11.151 of the Texas Education Code, which provides as follows:

> (a) The trustees of an independent school district constitute a body corporate and in the name of the district may acquire and hold real and personal property, sue and be sued, and receive bequests and donations or other moneys or funds coming legally into their hands.[52]

The Dallas Court rejected the contractor's interpretation of the statute, concluding that the language merely speaks to a district's capacity to sue and its capacity to be sued in the event that immunity has been otherwise waived.[53] The court concluded that, at a minimum, the statute was ambiguous as to the legislature's intent to waive a district's liability from suit, and the court was therefore required to construe the statute in a manner to protect the district's immunity.[54] Judge Lang of the Dallas Court authored a lengthy and detailed dissent to the opinion, arguing that the trial court incorrectly granted the plea to the jurisdiction based upon the development of sovereign immunity law.[55]

C. The Takings Claim Arguments

In *N.C. Sturgeon, L.P. v. Sul Ross State University*,[56] the Austin Court of Appeals addressed a waiver by conduct argument and an alternative takings claim by a contractor in the context of a construction project. During construction on the project, Sul Ross University withheld funds and then terminated the contract. Sturgeon sued, arguing breach of contract and a governmental taking. The university answered with a plea to

50. *Fid. & Deposit Co.*, 127 S.W.3d at 347.
51. Satterfield & Pontikes Constr., Inc. v. Irving Indep. Sch. Dist., 123 S.W.3d 63 (Tex. App.—Dallas 2003, no pet.).
52. Tex. Educ. Code Ann. § 11.151(a) (Vernon 1996).
53. *Satterfield*, 123 S.W.3d at 66 (citing City of Dallas v. Reata Construction Corp., 83 S.W.3d 392 (Tex. App.—Dallas 2002), *reversed*, 47 Tex. Sup. J. 408 (Tex. 2004)).
54. *Id.*
55. *Id.* at 69 (Lang, J. dissenting).
56. N.C. Sturgeon, L.P. v. Sul Ross State Univ., No. 03-01-00716-CV, 2003 Tex. App. LEXIS 331, at *1 (Tex. App.—Austin Jan. 16, 2003, pet. denied) (mem. op.).

the jurisdiction, which the trial court granted. The court affirmed, rejecting the arguments of Sturgeon regarding waiver by conduct and a takings claim.[57]

Sturgeon's brief was actually filed prior to the Texas Supreme Court's decision in *IT Davy* on the issue of waiver by conduct. The Austin Court of Appeals summarily rejected all of Sturgeon's arguments on that issue, holding that the supreme court had previously rejected all such concepts in the *IT Davy* decision.[58] The Austin Court declined Sturgeon's invitation to reconsider the supreme court's decision based upon Sturgeon's position that the supreme court's reasoning was "fundamentally wrong."[59]

In Sturgeon's second ground for appeal, it argued that the university had committed a governmental taking when it refused to pay the full contract price and terminated the contract. Sturgeon argued that it established a prima facie case of bad faith by the university.

The Austin Court began its discussion by reciting the rule that a party seeking to sue the State must show that the State's immunity from suit has been waived by express consent.[60] The court also noted, however, that a party suing for a constitutional taking does not have to show waiver of sovereign immunity before bringing suit.[61] That rule exists because a constitutional takings claim rests on the idea that, although the State has the right to take or use any property it needs to fulfill a public use, the State must pay just compensation to the property owner.[62] In order to recover under a takings claim, the claimant must establish that the State (1) intentionally acted in a manner which (2) resulted in the "taking" of property (3) for public use.[63] With respect to the first element, it is not sufficient to show that the State was negligent because intent to take or intent to perform the act which caused the harm is required.[64]

The Austin Court also outlined other standards for a takings claim, including that (1) in a contract, if the State acts within procedures set forth in the contract for withholding of materials, there is no intent to take; (2) if the State acts within a color of right to take or withhold property in a contract, there is no intent to take; and (3) if the State has a good faith belief that it is justified in withholding property or payment due to disagreement over performance, there is no intent to take.[65] In the context of a pleading for a takings claim, the court noted that conclusory allegations

57. *Id.*
58. *Id.* at *3.
59. *Id.* at *2.
60. *Id.* at *4.
61. *Id.* (citing Texas State Employees Union/CWA Local 6184 v. Texas Workforce Comm'n, 16 S.W.3d 61, 66 (Tex. App.—Austin 2000, no pet.)).
62. *Id.* at *5 (quoting Green Int'l, Inc. v. State, 877 S.W.2d 428, 433 (Tex. App.—Austin 1994, writ dism'd)).
63. *Id.*
64. *Id.*
65. *Id.* at *6.

of bad faith do not constitute proof of bad faith.[66]

Sturgeon's factual allegations in its pleadings were detailed and specific, stating all of the background information regarding the university's requirement of Sturgeon to perform corrective work, its withholding of funds, and its eventual termination of Sturgeon. The factual allegations also stated that the university had acted in bad faith and in disregard for the facts and for expert opinions with respect to the rejection of the work and failure to pay for work.

After reviewing the detailed pleadings, the Austin Court noted that the real dispute appeared to be the question of whether the masonry work on the project was in fact defective, and whether the university rightly or wrongly withheld full payment. The court noted that those disputes were inherently related to the provisions of the contract. Based upon that conclusion, the court held that "[a]ttempting to evade the reach of sovereign immunity by casting the dispute in terms of a takings claim does not change the inherent character of the contract dispute, and a party suing for breach of contract must obtain an express waiver of the State agency's immunity from suit."[67] The court also concluded that the university's pleadings indicated that it believed it was acting under its contractual rights and that the university lacked the intent to take Sturgeon's property.[68]

IV. LIEN RIGHTS, RETAINAGE , AND FUNDS TRAPPING

During 2003, the Texas Supreme Court and various Texas Courts of Appeals were very active in construing the Texas Property Code's provisions relating to lien rights, retainage, and funds trapping, as well as the law relating to constitutional lien rights.

A. Lien Rights and Retainage

In two companion cases issued in 2003, *Page v. Structural Wood Components, Inc.*[69] and *Page v. Marton Roofing, Inc.*,[70]the Texas Supreme Court addressed the issues of lien rights, retainage, and funds trapping, and reversed the decision of a Houston Court of Appeals on those issues. The two cases shared underlying facts, which involved a 1997 oral contract between Page and Custom Concrete to remodel and expand a building in Houston for $300,000. Page made periodic payments to Custom Concrete totaling $270,000. Marton Roofing ("MRI") was a subcontractor on the project. MRI completed its portion of the work on the project in March 1998. In April 1998, the contractor demanded that Page advance additional funds to complete the work, but Page refused and terminated the contract.

66. *Id.* at *8.
67. *Id.* at *16.
68. *Id.* at *17.
69. Page v. Structural Wood Components, Inc., 102 S.W.3d 720 (Tex. 2003).
70. Page v. Marton Roofing, Inc., 102 S.W.3d 733 (Tex. 2003).

Page then hired replacement contractors to complete the work and paid them a total of $30,657. The project was completed in full in July 1998, and the last payment was made at that time. When the original contractor failed to pay MRI, MRI sent notices of claims for more than $26,000 to the owner and contractors. MRI filed an affidavit for a mechanic's lien on June 15, 1998, and provided a copy to the owner. Both parties moved for summary judgment, and the trial court entered judgment in favor of MRI. Page then appealed, arguing that the trial court erred in concluding that MRI timely filed a perfected lien and complied with the fund-trapping provisions of the Texas Property Code.[71]

Because the contract at issue was entered into in 1997, the Houston court analyzed the version of the Property Code in effect at that time, noting that the owner was required to retain ten percent of the contract price for thirty days after work was completed and that a claimant can perfect a lien on the retained funds if he provides the proper notices and files an affidavit claiming a lien not later than the thirtieth day after the work is completed. While the parties acknowledge that MRI sent a proper notice and that Page properly retained funds on the project, they disagreed about whether the affidavit was timely filed.

The Houston Court of Appeals, which analyzed the Property Code, applied the statutory definitions of the terms "work" and "completion," noting that work is any part of construction performed under an original contract, and that completion means "the actual completion of the work, including any extras or change orders reasonably required or contemplated under the original contract, other than warranty or repair work."[72]

Page contended that work was completed when the original contractor demanded additional funds and the owner terminated it in April 1998. MRI contended that completion occurred in July 1998, when the other subcontractors completed the scope of work outlined in the original contract. The Houston Court of Appeals originally held that completion occurred in July 1998, when all of the work was concluded (regardless of the party who performed it), and that MRI's lien was timely filed. The Houston Court also concluded that nothing in the Property Code prevents a subcontractor from perfecting a lien separate from the original contractor's on retainage and that because the fund-trapping provisions have been held to benefit the subcontractor separate and apart from the contract, the lien was valid.[73]

The Texas Supreme Court disagreed with the holding of the Houston Court, as set forth in its two companion opinions. In the two decisions, the supreme court held that "work must be defined in relation to a partic-

71. Page v. Marton Roofing, Inc., 102 S.W.3d 750, 751 (Tex. App.—Houston [1st Dist.] 2002, *rev'd*, 102 S.W.3d 733 (Tex. 2003).

72. *Id.* at 751-52 (citing TEX. PROP. CODE ANN. §§ 53.001(14), 53.106(e) (Vernon 1995)).

73. *Id.* at 752-54.

ular contract" in order to determine the meaning of completion.[74] The court also noted that the greater weight of authority supported Page's contention that work ends when a contract is terminated.[75] As a result of its interpretation, the court concluded that a subcontractor must file its lien affidavit within thirty days of the time that the original contract is completed, terminated, or abandoned. Because MRI filed its affidavit two months after the original contract on the project was terminated, MRI's affidavit was untimely and did not perfect a lien on retainage.

The supreme court rejected the contention that a subcontractor must be able to rely upon the completion of work initially contemplated under the original contract in order to know when the thirty-day period begins to run, cautioning subcontractors that the best way to proceed is to file a lien affidavit within thirty days of completing their own work to be on the safe side.[76] The court's decision also pointed out that the Texas courts have long recognized that contract modifications, including termination, can change the amount of funds required to be retained and that it was consistent to say that contract modifications can also change the work contemplated by the contract and the retainage period.[77]

The supreme court also determined that MRI's attempt to perfect a fund-trapping lien failed for similar reasons. The court found that it was undisputed that Page neither made nor owed any further payments to the original contractor at the time after Page received notice of MRI's claims. Once again, the court held that fund-trapping liens must be judged in relation to individual original contracts, just as retainage liens.[78] MRI's notice authorized Page to withhold funds from the original contractor who had hired MRI. Page was not authorized to withhold funds from replacement contractors with no relationship to MRI. Accordingly, the court found that Page could not be liable under any fund-trapping statutes for funds paid to replacement contractors.[79]

B. Lien Rights against Subsequent Purchaser

In *Texas Wood Mill Cabinets, Inc. v. Butter*,[80] the Tyler Court of Appeals addressed the question of constructive notice of a mechanic's lien and the date of completion of underlying construction. In April 1999, D&D Construction asked Texas Wood Mill Cabinets ("TWM") to design and bid on cabinets for a spec home constructed on property which D&D owned. On April 5, TWM Cabinets made the required measurements, and it later entered into a contract to provide the cabinets. Installation

74. Page v. Marton Roofing, Inc., 102 S.W.3d 733, 734 (Tex. 2003); Page v. Structural Wood Components, Inc., 102 S.W.3d 720, 721 (Tex. 2003).
75. *Structural Wood Components*, 102 S.W.3d at 723.
76. *Id.* at 725.
77. *Id.* at 725-26.
78. Page v. Marton Roofing, Inc., 102 S.W.3d 733, 735 (Tex. 2003).
79. *Id.*
80. Tex. Wood Mill Cabinets, Inc. v. Butter, 117 S.W.3d 98 (Tex. App.—Tyler 2003, no pet.).

began in May 1999, and additional work was completed on June 17 and July 5.

On June 18, the Butters agreed to purchase the home from D&D and signed a contract for the purchase. The transaction closed on July 6. D&D did not pay TWM, and TWM filed a mechanic's lien affidavit on October 11, 1999 and served copies on both the Butters and D&D. On September 1, 2000, TWM sued the Butters to foreclose the lien. The Butters filed a general denial and argued they were subsequent purchasers without actual or constructive notice of TWM's lien.

After a non-jury trial, the court entered judgment for the Butters, with certain factual findings, included the following: (1) the debt of $12,884.84 was reasonable for the cabinet work and was due and owing to TWM; (2) TWM timely filed its lien affidavit; (3) the lien affidavit was properly perfected and related back to April 1999; (4) the Butters, as bona fide purchasers without actual or constructive knowledge of the cabinet work, were not bound by the lien; (5) though the Butters acquired the property subject to the lien right, TWM was not entitled to foreclose unless the Butters had either actual or constructive knowledge of the work or lien; (6) the Butters' personal knowledge that the work was new construction and that the improvements were made shortly before the July closing did not constitute constructive knowledge; (7) the Butters did not have actual or constructive knowledge of TWM's constitutional lien at the time of the purchase.[81]

TWM, on appeal, argued that there was insufficient evidence to support the finding that there was no actual or constructive notice of the lien right and that TWM's contract was completed in June 1999. The Butters argued that the lien affidavit was not timely filed.

The Tyler court first addressed the question of whether Section 53.052 (a) or (b) governed the dispute, since the construction at issue was a spec home.[82] Subsection (a) of the Texas Property Code requires a lien affidavit to be filed not later than the fifteenth day of the fourth calendar month after the indebtedness accrues, whereas subsection (b), which applies to residential construction, sets a deadline of the third calendar month.[83] The court carefully noted that a "residential construction project" means a project for the construction or repair of a new or existing residence provided by a "residential construction contract."[84] Because the house in question was a spec home, the court concluded that the work was not constructed under a "residential construction contract."[85] As a result, the fourth month deadline applied, not the third month deadline.

With respect to the question of when TWM's work was completed, the court referred to the ordinary meaning of the term "completed," which it

81. *Id.* at 101-02.
82. *Id.* at 103.
83. TEX. PROP. CODE ANN. § 53.052 (Vernon Supp. 2003).
84. *Tex. Wood Mill Cabinets, Inc.*, 117 S.W.3d at 103 (citing TEX. PROP. CODE ANN. § 53.001(10) (Vernon Supp. 2003)).
85. *Id.*

held to mean "ended" or "concluded."[86] Because the purpose of the contract between TWM and D&D was to construct and install cabinets, the contract was not completed until the cabinets were constructed, installed, and functional. In that context, the court held that initial construction did not constitute a completed installation. Rather, the work in adjustments to the cabinets in June and July constituted part of the required work, and work was therefore not completed until the final actions in July. The court noted that in July, TWM performed adjustments to the cabinets so that they were in compliance with the contract requirements and that no other work occurred after July.[87] The Tyler Court of Appeals therefore concluded that work was completed in July and sustained TWM's point of appeal.[88]

The court then conducted a very detailed analysis of the issues of notice and the impact of a lien right against a subsequent purchaser. The court's discussion began with a reference to the constitutional lien which is granted to an original contractor under the Texas Constitution, which the court noted is self-executing.[89] The court also noted, however, that a constitutional lien will not be enforced against a subsequent purchaser who has neither actual nor constructive notice of the lien.[90]

In that context, the court held that, in order for a contractor with a constitutional lien to protect his rights against a third party, the contractor must comply with the statutes relating to affidavits for fixing a mechanic's lien, thus giving constructive notice to third parties or giving actual notice to third parties within the time limits set by statute (and that lien will relate back to the inception of work on the contract).[91] The court outlined two separate rules of notice: (1) when a lien affidavit is filed after the sale of the property by the owner who contracted for the improvements, the purchaser is deemed to have constructive notice of a contractor's right to assert a lien for the statutory period, even when the filing period began before the purchase occurred; and (2) personal knowledge of the improvements made to the property at or shortly before the time of the purchase provides sufficient notice of a contractor's right to assert a lien.[92]

Because a purchaser has the burden to establish an affirmative defense of lack of knowledge, the court reviewed the evidence presented at trial. The purchaser testified that he was not a party to D&D's contract with TWM, that he obtained a title search before his purchase which revealed no liens, that he checked with D&D to determine if D&D owed money to anyone for work, that D&D told the purchasers that all bills were paid in full, that at closing D&D provided an affidavit stating that there were no

86. *Id.* at 103-04.
87. *Id.* at 104-05.
88. *Id.* at 105.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*

unpaid labor or materials claims, and that the purchaser was not aware that anyone had a right to file a lien. Based upon all of the evidence at trial, the court determined that the Butters did in fact have constructive notice of TWM's right to assert a lien, pointing to the fact that the Butters first saw the house when it was under construction and had knowledge that work continued between the time they saw the house in June and when they closed in July.[93] The court found that the evidence established that the purchasers had actual knowledge of ongoing work in June 1999, and that such knowledge was sufficient to charge the Butters with constructive knowledge of a right to assert lien claims.

The court rejected the Butters' arguments that prior cases had imputed constructive notice to a subsequent purchaser only where work was performed by the lien claimant at or after the date the purchaser took possession of the property or where the purchaser knew the identity of the contractor.[94] Rather, the court took a liberal approach to the concept, holding that it is a public policy to liberally construe mechanic's lien rights to protect laborers and materialmen.[95] Because TWM's lien affidavit was timely filed and because the court concluded that the Butters had constructive knowledge of a right to assert a lien, the court of appeals reversed the judgment of the trial court.[96]

C. Constitutional Liens

In *San Antonio Credit Union v. O'Connor*,[97] the San Antonio Court of Appeals confirmed that no jury questions are required in order to find a constitutional mechanic's lien. In that case, Mr. and Mrs. Jennings entered into a construction contract with Laco Construction. During the project, the parties encountered disagreements over payments due and work performed. The parties asserted various claims against one another, which were tried to a jury. The jury found in favor of Laco, and the trial court imposed a constitutional lien upon the property and issued a judgment for an order of sale to satisfy the lien.[98]

On appeal, the Jennings argued that the court's judgment was improper because the issue of the constitutional lien was not submitted to the jury. The jury had answered a question of whether the Jennings failed to comply with the written agreement with Laco affirmatively and found that Laco sustained damages of $33,000. Laco had claimed a constitutional lien in its pleading.

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93. *Id.*

94. *Id.* (distinguishing Valdez v. Diamond Shamrock Ref. & Mktg. Co., 842 S.W.2d 273 (Tex. 1992) and Inman v. Clark, 485 S.W.2d 372 (Tex. Civ. App.—Houston [1st. Dist.] 1972, no writ)).

95. *Id.* at 106.

96. *Id.*

97. San Antonio Credit Union v. O'Connor, 115 S.W.3d 82 (Tex. App—San Antonio 2003, pet. denied).

98. *Id.* at 107.

The Jennings argued that the question regarding the value of services used to complete the house and whether Laco had been paid for providing those services should have been submitted to the jury. The court rejected those arguments, holding that because a constitutional mechanic's lien is self-executing, it is automatic, and there are no issues which are necessary for a jury to determine relating to the lien itself.[99] The court concluded that "[b]eyond proof of the fact of the existence of the debt, which was found by the jury, and the fact of the labor having been performed, [which is undisputed,] there was no way of submitting the question of constitutional lien to the jury."[100]

D. Funds Trapping

In *In re Waterpoint Int'l*,[101] the Fifth Circuit Court of Appeals discussed the issue of funds trapping in the context of a case involving Exchanger Contractors, a subcontractor, which was not paid for its work by the contractor, Waterpoint International. Exchanger filed a declaratory judgment action seeking a determination of its rights under the trust fund provisions of the Texas Property Code for funds which were owed to the contractor by the owner. The contractor's lender, which held a security interest in the contractor's receivable from the owner, also sought relief. The Fifth Circuit Court affirmed the holding of the trial court that the lender was exempt from the trust fund provisions.[102]

Exchanger's claim requested that the court adjudicate Exchanger's rights to receivables owed by the owner to Waterpoint, upon which Waterpoint's lender claimed an interest. The lender argued that Exchanger had no claim to a portion of the receivable because lenders are specifically exempted by Chapter 162 of the Property Code. In the context of the disputes, the court examined both lien rights under Chapter 53 of the Texas Property Code and trust funds under Chapter 162 of the Property Code. The court pointed out that a subcontractor must comply with the filing requirements and deadlines under Chapter 53 of the Property Code in order to enforce rights against the property and property owner.[103] In contrast, the provisions of Chapter 162 provide that construction payments to contractors or subcontractors under a construction contract are deemed to be trust funds held for the benefit of laborers, without regard to the laborers' compliance with Chapter 53.[104] Chapter 162 was intended to serve as a special protection for subcontractors in situations where contractors refuse to pay subcontractors for labor or materials and imposes fiduciary responsibilities upon contractors to en-

99. *Id.* at 107.
100. *Id.* at 107-08 (quoting Weimhold v. Hyde, 294 S.W. 899, 900 (Tex. Civ. App.—Amarillo 1927, no writ)).
101. *In re* Waterpoint Int'l, LLC, 330 F.3d 339 (5th Cir. 2003).
102. *Id.* at 341.
103. *Id.* at 344.
104. *Id.* at 345.

sure that subcontractors are paid.[105]

The court also noted, however, the Section 162.004 states that Chapter 162 does not apply to a bank or other lender. Additionally, Chapter 162 does not permit a subcontractor to "trap" funds still in the hands of an owner as trust funds. Accordingly, the court rejected the arguments of Exchanger.[106]

V. LIMITATIONS, THE DISCOVERY RULE, AND FRAUDULENT CONCEALMENT

The San Antonio Court of Appeals had the opportunity during 2003 to review, in depth, the issue of limitations, the applicability of the discovery rule in the context of a construction dispute, and the impact of fraudulent concealment and intentional misrepresentations by a contractor. In *Booker v. Real Homes, Inc.*,[107] the court reviewed the limitations issues in the context of a summary judgment granted by the trial court in favor of the contractor, reversing in part and affirming in part.

The defendant contractor, Real Homes, built a residence for the Bookers, installing windows manufactured by a co-defendant, Marvin Windows. Construction continued on the house throughout 1997, although the Bookers moved into the residence in late 1996. As a result of construction defects, water began to seep into the house through and around the windows. Real Homes's summary judgment evidence indicated that the Bookers complained about leaks around windows as early as September 1997.

According to the Bookers' summary judgment evidence, they noticed a musty odor in their home in November 1997, which Real Homes investigated in January and April 1998, but took no action. In June 1998, the Bookers sent a certified letter to Real Homes, demanding that the issue be addressed. In September 1998, Real Homes removed sheetrock and found water damage and mold. In November 1998, Real Homes performed a water test and determined that the windows were the source of the water infiltration.

Real Homes and Marvin began to perform repairs in November 1998, and work continued until January or February 1999. Although the Bookers were told that the problem had been repaired, the musty odor returned. The Bookers sent a letter about the odor to Real Homes in April 1999. Real Homes responded that the odor was coming from outside the house and took no further action. In July 1999, the Bookers cut a hole in a wall beneath the windows in a room and discovered wet and rotten wood.

On October 13, 1999, the Bookers filed suit against Real Homes and Marvin, alleging contract and warranty theories, negligence, negligent

105. *Id.*
106. *Id.* at 349.
107. Booker v. Real Homes, Inc., 103 S.W.3d 487 (Tex. App.—San Antonio 2003, pet. denied).

misrepresentation, and violations of the DTPA. The defendants moved for summary judgment, arguing that the causes of action for negligence, gross negligence, negligent misrepresentation, intentional infliction of emotional distress, and violations of the DTPA were barred by the two-year limitations period. The trial court granted the motion, and the Bookers appealed.[108]

In its discussion regarding the standard for summary judgment, the San Antonio Court of Appeals reiterated the well-accepted principles that a defendant seeking summary judgment based upon limitations must establish when the cause of action accrued and must negate the application of the discovery rule if pled by the non-movant.[109] The discovery rule applies where an injured party did not and could not know of its injury at the time it occurred, and where the injury was inherently undiscoverable. Under the discovery rule, the limitations period does not begin to run when the first damage is observed or when the full extent of damage is known, but rather when the injured party knew or should have known of the facts giving rise to a cause of action.[110]

The Bookers argued that the limitations period did not begin until they knew of the exact cause of the leaks, not just about the leaks themselves, but the court disagreed, holding that all that was required was the discovery of an injury and its general cause, not a specific cause. Under the facts of the case, the court concluded that limitations was tolled until the date when the Bookers actually knew about the leaks.[111] Because the Bookers pled the discovery rule, it was the burden of the other parties to establish when the Bookers discovered, or should have discovered, the injury. The evidence indicated that the Bookers were aware of leaks in the windows as early as September 1997, and therefore the court held that limitations began to run then.[112]

The Bookers also alleged that the builder fraudulently concealed and intentionally misrepresented the true facts of the problems to them. The court noted that fraudulent concealment estops a defendant from using limitations as a defense and that it is the burden of the plaintiff to raise the issue because it is an affirmative defense to limitations. Under Texas law, to show that fraudulent concealment applies, the plaintiff must show that the defendant had actual knowledge of the wrong, a duty to disclose the wrong, and a fixed purpose to conceal the wrong.[113] The doctrine of fraudulent concealment suspends the running of the limitations period after it has begun because the defendant concealed facts necessary for the plaintiff to know that a claim existed, but the estoppel effect is not permanent.[114] Knowledge of facts which would cause a reasonable person to

108. *Id.* at 490.
109. *Id.* at 491.
110. *Id.* at 491-92.
111. *Id.* at 492.
112. *Id.* at 493.
113. *Id.*
114. *Id.*

inquire and discover a concealed condition then becomes the equivalent of knowledge of the injury for limitations purposes. Based upon the evidence in the record, the court reversed summary judgment in favor of Real Homes on the basis of the fraudulent concealment doctrine.[115]

VI. ARBITRATION CLAUSES AND RIGHTS

During late 2002 and 2003, the Texas courts were very busy analyzing issues associated with arbitration provisions, and they issued a number of opinions regarding those issues. During that time period, the Texas Supreme Court issued various opinions analyzing the issue of arbitration agreements within the context of construction disputes. In those decisions, the supreme court emphasized the binding nature of arbitration, the broad powers of the arbitrators, the courts' very limited powers of review, and the parties' rights under that form of alternative dispute resolution. In addition, various courts of appeals issued opinions regarding the way arbitration clauses would be applied.

A. ARBITRATION AWARDS NOT SUBJECT TO REVIEW, EXCEPT ON LIMITED GROUNDS

In *Callahan & Associates v. Orangefield Independent School District*,[116] the Texas Supreme Court outlined the extremely limited authority which any trial court or appeals court has in reviewing an arbitration award. The opinion emphasizes the very broad powers of the arbitrator in a case which requires arbitration, and the fact that parties likely have no recourse in the courts for legal errors committed by an arbitrator.

In the case, the school district hired Callahan, an architectural firm, to provide architectural services for the construction of an elementary school. The contract described both "basic" and "additional" services, and it required the school district to pay Callahan specified fees for both. The contract also required arbitration for any disputes that arose. After the project was substantially complete, the district discovered problems with the work, including a driveway that developed soft spots and then cracked and broke. The parties entered into an agreement to resolve their disputes and close the project. However, several months later, the district sued Callahan for breach of contract and negligence. Callahan asserted counterclaims for additional services it performed. The trial court stayed the proceedings to allow the parties to arbitrate, as required in their original contract.

In the arbitration, Callahan sought unpaid fees from the district for both basic and additional services it alleged it performed on the driveway. The district sought damages for several matters, including the driveway and its replacement with concrete, when the original material had been

115. *Id.* at 494.
116. Callahan & Assoc. v. Orangfield Indep. Sch. Dist., 92 S.W.3d 841 (Tex. 2002).

less expensive asphalt. The district did not present evidence of the cost to replace the driveway with asphalt.

The arbitrator denied the district's claims and determined that Callahan was entitled to be paid additional fees of almost $90,000. The written "reasons for award" issued by the arbitrator indicated that the district could not recover damages for its costs to replace the driveway because, although both Callahan and the contractor were at fault, there was no evidence of the cost to replace the driveway with asphalt. Additionally, the arbitrator determined that Callahan had provided additional services, and that the agreement entered into at the end of the project did not require Callahan to perform without additional charge, because the parties did not "effectuate" that agreement.[117]

The trial court severed the arbitrated claims from the underlying suit, and the district filed an application to vacate, modify, or correct the arbitration award. Both parties filed motions for summary judgment. The district, in its motion, argued that the arbitrator had exceeded her powers, made evident mistakes, and violated common law in awarding damages to Callahan and denying damages to the district. Callahan argued in its motion that there was no reason to modify the arbitrator's award, and that the trial court should enter judgment per that award. The trial court granted Callahan's motion and entered judgment in accordance with the arbitrator's ruling.[118]

In the court of appeals, the district argued that the arbitrator made an "evident mistake and violated common law" by not awarding the district damages to replace the defective driveway. The court of appeals concluded that the record did contain evidence about the replacement cost to raise a genuine issue of material fact regarding whether the arbitrator made an evident mistake or violated the common law.[119] The court of appeals, therefore, reversed the judgment in part, and remanded the case to the trial court to make findings about the damages to the district. The court of appeals rejected the district's argument that the award to Callahan should be reversed because it found that the district waived its position by failing to raise it during the arbitration.[120]

On appeal to the Texas Supreme Court, Callahan requested a reversal of the court of appeals's decision, based upon its argument that the court did not have the authority to disturb an arbitration award. The parties and the court agreed that the Texas Arbitration Act[121] governed the dispute. The court found that the Act requires a court to confirm an arbitrator's award upon a party's application, unless a party offers grounds for vacating, modifying, or correcting the award.[122] The court found that the Act does not allow a reviewing court to modify or correct an award based

117. *Id.* at 842-43.
118. *Id.* at 843.
119. *Id.*
120. *Id.*
121. TEX. CIV. PRAC. & REM. CODE § 171.001.
122. *Callahan*, 92 S.W.3d at 844 (citing TEX. CIV. PRAC. & REM. CODE § 171.087).

upon an arbitrator's "evident mistake" in failing to award damages, but rather permits a court to modify or correct an award that contained an "evident miscalculation of figures" or an "evident mistaken in the description of a person, thing, or property referred to in the award."[123] The court concluded that, because an arbitrator's failure to award damages is not a ground under the Act for modifying an award, the court of appeals erred in reversing the summary judgment.[124]

B. Arbitration Results are Binding, Except in Limited Circumstances

In *CVN Group, Inc. v. Delgado*,[125] the Texas Supreme Court once again emphasized the binding nature of arbitration and refused to reverse an arbitrator's award, even though a court of appeals found that the award was erroneous under Texas law.

In the case, the Delgados hired CVN Group to provide construction services. The written contract between the parties required arbitration of any disputes. Before construction was completed, the Delgados instructed CVN to stop work. CVN alleged that the Delgados had materially breached the contract and demanded arbitration.

The parties submitted their dispute on documents and briefs, without live testimony (as agreed upon in the original contract). CVN requested more than $156,000 in damages plus a lien against the homestead at issue. The Delgados responded that they did not owe any fees to CVN and that the lien claimed was invalid because CVN filed its lien affidavit late and did not record the original contract, as required by the Texas Property Code. The Delgados did not challenge the arbitrator's authority to decide the lien dispute. The arbitrator awarded CVN more than $110,000 in damages and found "valid statutory and constitutional mechanic's liens for the full award."[126]

CVN applied to the district court to confirm the award and foreclose the mechanic's lien. The Delgados argued that the award should be vacated or modified because the award was "manifestly unjust and constituted usury," there was no evidence that the lien satisfied the necessary constitutional and statutory requirements, and granting the lien violated the Delgados' constitutional rights and exceeded the authority of the arbitrator.[127] The trial court found that the award should be reduced to approximately $23,000 and that CVN was not entitled to foreclose its mechanic's lien because it had not complied with any of the constitutional and statutory requirements for obtaining a lien.[128] The court of appeals then reversed the trial court's reduction of the damages, but affirmed the

123. *Id.* (citing Tex. Civ. Prac. & Rem. Code § 171.091(a)(1)).
124. *Id.*
125. CVN Group, Inc. v. Delgado, 95 S.W.3d 234 (Tex. 2002).
126. *Id.* at 235.
127. *Id.* at 236.
128. *Id.* at 236-37.

trial court's refusal to foreclose CVN's mechanic's liens, noting that a mechanic's lien can be foreclosed by judicial action only and that a court must review the validity of a lien prior to ordering any foreclosure.[129] Factually, the court of appeals determined that CVN had failed to prove that it had a signed contract with the Delgados, that it had filed the contract in the real property records, and that it had timely filed a lien affidavit.

On appeal to the Texas Supreme Court, the Delgados argued that a court has the power to overturn an arbitration award that is unconstitutional or otherwise violates public policy. In the context of its discussion, the supreme court reviewed Section 171.088(a) of the Texas Arbitration Act,[130] as well as it prior opinion in *Smith v. Gladney*,[131] which held that a claim arising out of an illegal transaction is not a legitimate subject of arbitration and that an award in such a case is void and unenforceable in courts of law. On both grounds, the court determined that there was no basis to overturn the arbitration award in question, because there was no proof of corruption by the arbitrator and no evidence that the transaction in question was illegal. The court's conclusion makes its point:

> Subjecting arbitration awards to judicial review adds expense and delay, thereby diminishing the benefits of arbitration as an efficient, economical system for resolving disputes. Accordingly, we have long held that an award of arbitrators upon matters submitted to them is given the same effect as the judgment of a court of last resort. All reasonable presumptions are indulged in favor of the award, and none against it.[132]

Thus, the court concluded that an arbitration award cannot be set aside on public policy grounds except in an extraordinary case where the award violated a carefully articulated, fundamental policy. Although the Delgados argued that awarding a mechanic's lien on a homestead would satisfy that requirement, the court disagreed, holding that the issues had been submitted to the arbitrator, and decided in favor of CVN.[133] The court even stated that nothing in the arbitration proceeding indicated that the arbitrator completely disregarded the requirements for perfecting mechanic's liens, although both the trial court and court of appeals found that decision erroneous.[134]

Finally, the court disagreed with the contention in the dissenting opinion that the validity of a mechanic's lien can never be arbitrated, regardless of the parties' agreement, as a result of Section 53.154 of the Texas Property Code, which requires foreclosure only on judgment of a court.[135] The majority opinion found that nothing in the language or his-

129. *Id.* at 236 (citing TEX. PROP. CODE ANN. § 53.154).
130. TEX. CIV. PRAC. & REM. CODE ANN. § 171.088(a) (Vernon Supp. 2003).
131. Smith v. Gladney, 128 Tex. 354, 98 S.W.2d 351 (1936).
132. *CVN Group, Inc.*, 95 S.W.3d at 238 (citations omitted).
133. *Id.* at 239.
134. *Id.*
135. *Id.*

tory of Section 53.154 supporting the dissent's arguments.

This decision presents an extreme set of facts, where it appears that a contractor did not fulfill the requirements of the Property Code to perfect a mechanic's lien on a homestead, but was nevertheless permitted to foreclose that lien. The decision points out the results which parties may face by agreeing to arbitration, where even an obvious error cannot be corrected by judicial action or otherwise.

C. Arbitration Clauses Strictly Enforced

In *In re First Texas Homes, Inc.*,[136] the Texas Supreme Court strictly enforced the scope of an arbitration agreement between the parties to a construction contract. The parties in that case entered into a home construction contract which specified that they would arbitrate, under the Federal Arbitration Act, "all disputes" which arose between them. The term "dispute" was broadly defined to include all claims, demands, disputes, controversies, and differences of any kind or nature. The homeowners sued on a number of contractual and tort theories, but also asserted that the builder had violated the Texas Fair Housing Act and Federal Fair Housing Act through racial discrimination. The trial court ordered some, but not all, of the homeowners' claims to arbitration, and the home builder appealed. The trial court did not require the Fair Housing claims or an intentional infliction of emotional distress claim to be arbitrated, because those claims arose after the signing of the contract in question.[137]

In the mandamus action, the Texas Supreme Court held that all disputes between the parties, including those claims asserted under the Fair Housing legislation, and all claims that arose before, during, or after the contract was signed, were required to be arbitrated pursuant to the broad clause in the parties' agreement.[138]

D. No Undue Delay Found in Arbitration Demand

In *Williams Industries, Inc. v. Earth Development Systems Corp.*,[139] the Houston Court of Appeals concluded that a seventeen month delay in seeking to enforce a right of arbitration was not sufficient to show prejudice and, therefore, did not waive the right to enforce the arbitration clause.[140] In the case, Earth Development Systems ("EDS"), a subcontractor, filed suit in January 2001, against Williams Industries, the contractor, and other parties for breach of contract and various torts associated with two separate construction projects. The parties amended their pleadings and continued to add additional parties over the next

136. *In re* First Tex. Homes, Inc., 120 S.W.3d 868 (Tex. 2003).
137. *Id.* at 869.
138. *Id.* at 870.
139. Williams Indus., Inc. v. Earth Dev. Sys. Corp., 110 S.W.3d 131 (Tex. App.—Houston [1st Dist.] 2003, no pet.).
140. *Id.* at 139.

year-and-a-half. Seventeen months after the suit was originally filed, Williams filed a motion to compel arbitration and to stay the litigation pursuant to arbitration clauses in the contracts in question. EDS argued that not all of its claims fell under the arbitration agreements, and that the contractor had waived the right to arbitrate because of its delay in making the request. The trial court denied the motion to compel arbitration, but the Houston court reversed in the interlocutory appeal which followed.

The court noted that, because public policy favors arbitration, there is a strong presumption against a finding of waiver of the right to arbitrate, and the burden to prove waiver is a very heavy one.[141] The court found that waiver may be express or implied, but that it must be intentional, and that the following are required to prove waiver: (1) substantial invocation of the judicial process by the party seeking arbitration and (2) actual prejudice to the party opposing arbitration.[142]

In reviewing the facts of the case, the Houston court concluded that substantially invoking the judicial process can occur when the requesting party tried, but failed, to achieve a satisfactory result in litigation before requesting arbitration, and the court gave an example of an unsuccessful summary judgment motion. The analysis of prejudice focuses on factors such as a party's access to information not discoverable in arbitration and the costs and fees due to a movant's delay.

EDS, which opposed arbitration in the case, relied upon evidence that Williams had answered a lawsuit, waited seventeen months to request arbitration, engaged in written discovery, filed a cross petition, demanded a jury and paid a jury fee, and moved for continuances. EDS argued that it was prejudiced by having to answer discovery and engage in discovery not permitted in arbitration, incurring costs associated with discovery, not opposing continuance, and having to pay arbitration fees. In light of these facts, the court concluded that mere delay and expense alone did not show prejudice and that EDS had not carried its substantial burden to establish prejudice.[143]

E. Non Signatory Required to Arbitrate

The Houston Court of Appeals confirmed that a nonsignatory to a construction contract who relies upon that contract can be required to arbitrate, if the parties to the contract are required to arbitrate, in *In re Macgregor*.[144] In that case, a contractor and subcontractor entered into a contract relating to the construction of elevators for a cruise ship, which contained an arbitration clause. The subcontractor made partial payments to a sub-subcontractor as work proceeded, but did not pay in full. A payment dispute between the contractor and subcontractor went to

141. *Id.* at 135.
142. *Id.*
143. *Id.* at 141.
144. *In re* Macgregor, 126 S.W.3d 176 (Tex. App.—Houston [1st Dist.] 2003, no pet.).

arbitration, and the court held that the sub-subcontractor's related claims would also be required to be arbitrated.

In its discussion, the court concluded that a nonsignatory to a contract may be bound by the terms of an arbitration provision of that agreement if the non-signatory asserts claims that require reliance on the terms of the agreement.[145] The court focused its analysis of the actions of the non-signatory, not the relationship to the signatories in reaching its conclusion that the sub-subcontractor would be required to arbitrate as well.[146] Because the sub-subcontractor's claims arise out of or touches on matters covered by the contract between the contractor and subcontractor, the court concluded that the claims were inextricably intertwined with the contract dispute and were therefore subject to arbitration as well.[147]

F. No Arbitrator Misconduct Found

In *Peacock v. Wave Tec Pools, Inc.*,[148] the Waco Court of Appeals reviewed various aspects of a case which had previously been arbitrated. The homeowners who had contracted for the construction of a pool filed a petition in the trial court seeking to modify or vacate an arbitration order. The trial court confirmed the award, and the court of appeals reversed in part.

The construction contract between the Peacocks and Wave Tec contained an arbitration clause, and the parties agreed to arbitrate their disagreements regarding the construction of the pool under the rules of the Better Business Bureau. The Peacocks identified the nature of the dispute by stating that the pool was defective and the workmanship substandard. The decision sought under the rules was identified as "new pool, or reimbursement of amounts paid, payment by Wave Tec of amount necessary to complete and repair pool." The agreement stated that the arbitrator's decision could not exceed what was specified in the "decision sought" section.[149]

In the underlying arbitration, the arbitrator rendered a decision requiring Wave Tec to repair the pool, subject to the Peacocks' approval. If the Peacocks did not approve the work, the arbitrator would engage an expert to review the repairs. The Peacocks were ordered to pay Wave Tec $10,500 over the contract price for rock removal because of unforeseen circumstances.

The Peacocks complained that the award was void because it lacked finality and went beyond the scope of the arbitration agreement. The arbitrator had labeled the award "interim" and established a procedure to follow, but retained the right to engage an expert to inspect repairs.

145. *Id.* at 183.
146. *Id.*
147. *Id.*
148. Peacock v. Wave Tec Pools, Inc., 107 S.W.3d 631 (Tex. App.—Waco 2003, pet. denied).
149. *Id.* at 635.

The Peacocks argued that the award was therefore not final and that a trial court could not confirm it. The Better Business Bureau rules permitted an arbitrator to issue a final or an interim decision. Based upon those rules, the court concluded that the arbitrator was permitted to enter the award he did, that the reserve of authority was ministerial in nature (to appoint an expert), and that the award did not lack finality.[150]

The Waco court also carefully reviewed the scope of the arbitration agreement and the agreement on the scope of the award to be made in order to determine whether the arbitrator exceeded his authority. The court noted that the Peacocks had requested a new pool or reimbursement of amounts paid and payment by Wave Tec to complete the pool. The court concluded that ordering Wave Tec to repair the pool at its own expense was within the scope of the agreement to arbitrate, but that the issue regarding compensation for additional rock work was not because Wave Tec did not specifically identify that issue in the agreement.[151]

Finally, the Waco court concluded that the arbitrator's actions in soliciting advice from technical experts without including the parties did not constitute "misconduct" which would require the vacation of the arbitration award. The court held that the level of misconduct required would be that to deprive the parties of a fair hearing and that no such evidence existed.[152]

VII. CONTRACTOR LIABILITY FOR SUBCONTRACTOR'S EMPLOYEES

As discussed in prior articles, the Texas Supreme Court during 2001 and 2002, had the opportunity to analyze in some detail the prerequisites for holding a contractor liable for the negligence of a subcontractor's employees. In *Lee Lewis Construction, Inc. v. Harrison*[153] and *Dow Chemical Co. v. Bright*,[154] the court outlined the elements of control which the court required in order to find liability of a contractor for acts of a subcontractor's employees.

During 2003, the Austin Court of Appeals had the opportunity to apply those principles in its decision in *Qwest Communications Int'l, Inc. v. AT&T Corp.*[155] The facts in the *Qwest* case involved the construction of nationwide fiber-optic communications networks by Qwest, in order to compete against AT&T and other companies. In 1996, Qwest was laying fiber optic cable in highway right-of-ways between Austin, San Antonio, and Houston. AT&T's fiber-optic cables already in existence were also buried in the same rights-of-way. Qwest informed AT&T of its activities,

150. *Id.* at 637.
151. *Id.* at 639.
152. *Id.* at 640.
153. Lee Lewis Constr., Inc. v. Harrison, 70 S.W.3d 778 (Tex. 2001).
154. Dow Chem. Co. v. Bright, 89 S.W.3d 602 (Tex. 2002).
155. Qwest Communications Int'l, Inc. v. AT&T Corp., 114 S.W.3d 15 (Tex. App.—Austin 2003, pet. filed).

and AT&T had representatives on site to aid in the coordination of the efforts and to mark the AT&T cables to prevent damage to them.

In order to conduct the required work, Qwest hired C&S Directional Boring Company, Inc. ("C&S") as a subcontractor, and C&S hired a company called CK Directional Drilling as its subcontractor. On September 16, 1997, Qwest severed one of AT&T's cables. In October and December 1997, CK severed the cable a second and third time. AT&T filed suit against Qwest and C&S seeking damages and other relief. At trial, the District Court in Travis County awarded economic and exemplary damages to AT&T. On appeal, Qwest argued that it should not have been held liable for the acts of C&S and CK.

At trial, the district court submitted four questions to the jury concerning whether C&S was under Qwest's control and whether CK was under C&S's control during the construction and second and third cuts. With respect to the second and third cuts, the questions submitted to the jury included (1) whether C&S was "conducting operations for the benefit of Qwest and subject to the control by Qwest as to the detail of the work" and (2) whether CK was "conducting operations for the benefit of C&S Boring and subject to control by C&S Boring as to the details of its work."[156] Qwest made two arguments on appeal: (1) because AT&T did not request a question as to whether Qwest controlled the details of CK's work and the questions did not submit a respondeat superior theory for CK, AT&T waived the theory as between Qwest and CK; and (2) the evidence as to the contractors' lack of independence was legally and factually sufficient.

The Austin Court of Appeals began its discussion with the general rule that an employer or owner is not liable for the acts of its independent contractors, citing various cases.[157] The court specified that for a general contractor to be liable for its independent contractor's acts, it must have the right to control the means, methods, or details of the work.[158] The court also specified that the control must relate to the injury the negligence causes, and the contract must grant the contractor at least the power to direct the order in which work is performed.[159]

The court of appeals's first concluded that the evidence presented was sufficient to support the judgment of liability of Qwest, finding evidence of both actual control and the contractual right to control.[160] The court noted that C&S contractually retained some control over CK's work, and CK personnel exercised some oversight with regard to C&S's operations. C&S retained the right to control CK's hiring decisions in its contract. CK and C&S shared equipment, and the court noted that there was no practical difference between CK and C&S. In addition, the court found

156. *Id.* at 34.
157. *Id.*
158. *Id.* (citing Lee Lewis Constr., Inc. v. Harrison, 70 S.W.2d 778 (Tex. 2001)).
159. *Id.*
160. *Id.* at 35.

that Qwest's contract specified that Qwest had the right to direct and control C&S, including details of the work, and that Qwest exercised such control.

The court also rejected Qwest's theory regarding jury questions, holding that where issues that constitute only a part of a complete and independent ground are omitted and other issues necessarily referable to that ground are submitted and answered, the omitted elements are deemed found in support of the judgment if no objection to the omitted elements is made, and the answers are supported by some evidence.[161] The court noted that it was AT&T's burden to obtain an affirmative finding of Qwest's control over CK, but that it was Qwest's burden to object to the omission. Because Qwest did not object, and because the omitted issue constituted only a part of a complete and independent ground of recovery, the other evidence at trial supporting the finding.[162] The court of appeals affirmed the trial court judgment, concluding that the evidence supported a finding that Qwest controlled C&S, that C&S controlled CK, and that Qwest controlled CK.[163]

VIII. RESIDENTIAL CONSTRUCTION LIABILITY ACT

In 2003, there were few opinions interpreting the Residential Construction Liability Act ("RCLA"). However, both the Austin and San Antonio courts addressed various aspects of the Act.

A. The RCLA Governs all Residential Construction Disputes

In *F&S Construction, Inc. v. Saidi*,[164] the San Antonio Court of Appeals addressed the question of whether a homeowner is required to specifically plead the Residential Construction Liability Act in order to recover under that statute. In September 1997, the Saidis executed a contract with F&S Construction for the construction of a new home. After they determined that they were not satisfied with the quality of the work performed, the Saidis terminated the contract with F&S. In December 1998, F&S sued the Saidis for money owed under the contract. The Saidis filed an answer and counterclaim. The counterclaim alleged breach of contract, fraud, and DTPA claims, and requested damages and attorneys' fees. In May 2002, two weeks before trial, F&S filed a verified plea in abatement, arguing that the Saidis had not complied with the RCLA because they had not provided reasonable specificity of the construction defects alleged in the counterclaim and had not provided an opportunity for the contractor to view the property. Both parties further amended their pleadings before trial.

161. *Id.* at 36 (citing Tex. R. Civ. Proc. 279).
162. *Id.*
163. *Id.* at 46.
164. F&S Constr., Inc. v. Saidi, No. 04-02-00649-CV, 2003 Tex. App. LEXIS 10769, at *1 (Tex. App.—San Antonio Dec. 24, 2003, no pet. h.).

A jury awarded the Saidis more than $170,000 in damages and attorneys' fees. F&S appealed the denial of its plea in abatement and argued that the evidence was not sufficient to support the findings that the Saidis gave F&S reasonable detail of the defects and an opportunity to inspect the home.

The court began its analysis with a general description of the RCLA, noting that all claims to recover damages resulting from construction of a residence fall within the purview of the RCLA.[165] The court also pointed out the requirement that a claimant must give sixty days written notice of claims before filing suit, although that requirement does not apply in the case of a counterclaim.[166] In lieu of that notice requirement, a counterclaimant is required to specify, in reasonable detail in his pleading, each construction defect which is the subject of the claims.[167] While the court noted that the statute does not specify what language constitutes reasonable detail of the defects, the purpose of the notice is to encourage pre-suit negotiations and to avoid the expense of litigation.[168]

In the Saidis' pleadings, the homeowners alleged problems with four separate scopes of work, and later supplemented that description with fourteen detailed complaints. In the context of the case of first impression, the court concluded that the four separate categories which were described were sufficient to provide F&S with notice of the alleged defects. Because the jury's findings were supported by more than a scintilla of evidence, the court of appeals upheld the jury's findings.[169] The court also found evidence in the record that the homeowners did permit an inspection of the property, satisfying the requirement under the statute.[170]

B. THE RCLA PERMITS ADR OTHER THAN MEDIATION

In *High Valley Homes, Inc. v Fudge*,[171] the court determined that the parties to a residential construction contract can agree to forms of alternative dispute resolution other than mediation, even in light of the provisions of the RCLA.[172] Mr. and Mrs. Fudge entered into a contract with High Valley Homes for the construction of a home. During construction, with input from their architect, the Fudges terminated the contract with High Valley as a result of construction defects. The Fudges filed suit for declaratory judgment seeking to invalidate a mechanic's lien filed by High Valley and for damages under the DTPA. High Valley answered that the case was governed by the RCLA and that the Fudges had failed

165. *Id.* at *5-6.
166. *Id.* at *6-7 (citing TEX. PROP. CODE ANN. § 27.004(c)).
167. *Id.* at *7.
168. *Id.*
169. *Id.* at *9.
170. *Id.*
171. High Valley Homes, Inc. v. Fudge, No. 03-01-00726-CV, 2003 Tex. App. LEXIS 3273 (Tex. App.—Austin Apr. 17, 2003, no pet.) (mem. op.).
172. *Id.* at *7.

to provide sufficient notice of alleged defects. Later, High Valley also filed a motion to require mediation, arguing that the contract contained a mediation clause and that the Fudges had failed to mediate the case.

During the hearing on that motion, the parties were ordered to participate in arbitration. Following the arbitration of all claims, the Fudges received judgment in their favor. High Valley appealed on various grounds, including a claim that the trial court erred in requiring arbitration when High Valley requested mediation and the contract and the RCLA permitted mediation.

The court concluded that the RCLA authorizes, but does not require, mediation by the parties.[173] High Valley argued that the Fudges' claims did fall within the scope of the RCLA, and because the RCLA calls for mediation, the court erred in requiring arbitration. The court rejected the concept that because the RCLA refers to mediation the RCLA would displace otherwise binding agreements entered into by the parties.[174] The court concluded that, if the legislature had intended for mediation provided for in the statute to preempt private contracts and other ADR methods, it would have plainly stated that rule.[175]

IX. THE SUBSTANTIAL PERFORMANCE DOCTRINE

In 2002, the appellate courts addressed two separate interesting cases on the doctrine of substantial performance and its relationship to a party's ability to sue for breach of a construction contract.

A. The Relationship Between Substantial Completion and Jury Findings

In *Movie Grill Concepts I, Ltd. v. CCM Group, Inc.*,[176] the Dallas Court of Appeals addressed the question of possibly conflicting jury findings on the issues of substantial completion and breach of contract.

Movie Grill contracted with CCM to renovate a movie theater, and the parties signed an original contract and various change orders. CCM sued Movie Grill, alleging that CCM substantially performed, but that Movie Grill failed to pay all that was owed on the contract. CCM alleged that it was owed more than $310,000 after allowing for credits and offsets. CCM filed claims for breach of contract, sworn account, quantum meruit, and fraud, among others. Movie Grill counterclaimed, alleging that CCM failed to complete the renovation for the agreed price and failed to perform in a good and workmanlike manner, thus breaching the contract.[177]

The jury found that both CCM and Movie Grill breached the contract, that Movie Grill was excused from compliance with the agreements be-

173. *Id.* at *6.
174. *Id.* at *7.
175. *Id.*
176. Movie Grill Concepts I, Ltd. v. CCM Group, Inc., No. 05-02-00892-CV, 2003 Tex. App. LEXIS 1752, at *1 (Tex. App.—Dallas Feb. 27, 2003, pet. denied) (mem. op.).
177. *Id.* at *2-3.

cause of CCM's material breach, that CCM substantially performed, and that the value of the performance was $70,445. Movie Grill appealed, arguing that the trial court erred in entering judgment for CCM because the jury's finding that CCM substantially performed was irrelevant in light of the finding that Movie Grill was excused from further performance.

A careful review of the factual findings by the jury would raise some questions regarding the consistency of the findings, but the court of appeals found that it was required to reconcile apparent conflicts in the findings if reasonably possible in light of the pleadings and evidence. In response to question 1, the jury found that both CCM and Movie Grill failed to comply with the agreements. In question 3, the jury found that Movie Grill's failure to comply was excused by CCM's failure to comply with material obligations of the agreement. In question 9, the jury found that CCM had substantially performed under the contract. CCM argued that nothing in the record showed that questions 3 and 9 addressed the same facts, and the Dallas court agreed that it could not say, as a matter of law, that the findings were in conflict.[178]

Movie Grill also argued that a finding of material breach by CCM precluded recovery on a substantial performance theory. The court held that the substantial performance doctrine is a doctrine that allows breaching parties who have substantially completed their obligations to recover on a contract.[179] The court specifically referred to the doctrine that when a contractor had substantially performed a building contract, he is entitled to recover the contract price less the cost to remedy the defects that can be remedied. The court then found that that issues of remediable defects were addressed in two additional questions, where the jury found that there were no damages to Movie Grill based upon CCM's breach of the contract. As a result, the court upheld the jury verdict.[180]

B. The Impact of Substantial Completion

In *Celtic Constructors, Inc. v. Van Pelt*,[181] the Houston Court of Appeals addressed the question of whether a party who only substantially complies with a construction contract can sue for breach of contract. The Van Pelts entered into a construction contract with Celtic to remodel a home. Celtic stopped work before the job was completed because it alleged that the Van Pelts had stopped paying as agreed. Celtic sued the Van Pelts for breach of contract and quantum meruit. The Van Pelts counterclaimed, arguing that Celtic had not performed in a good and workmanlike manner. The trial court granted Celtic's motion for sum-

178. *Id.* at *7.
179. *Id.*
180. *Id.* at *9.
181. Celtic Constructors, Inc. v. Van Pelt, No. 01-02-00012-CV, 2002 Tex. App. LEXIS 8861, at *1 (Tex. App.—Houston [1st Dist.] Dec. 12, 2002, no pet.) (not designated for publication).

mary judgment on the counterclaims, and Celtic's claims were tried before a jury. The court granted the Van Pelts' motion for a directed verdict on the issue of breach of contract. The jury, proceeding on the quantum meruit claim, found that the Van Pelts failed to comply with the agreement and that the reasonable value of the work performed by Celtic was $56,570.

With respect to the breach of contract action, the court held that a party to a contract who is in default generally cannot maintain a suit for breach.[182] The court recognized the exception to the rule in the context of construction projects, where a party can establish that it has substantially completed work on the project.[183] In that claim, the contractor has the burden of proving that it did substantially perform.[184]

Because it was uncontroverted that Celtic did not complete the contract, the only contract cause of action at trial could have been substantial performance. However, Celtic did not plead substantial performance. The court, therefore, concluded that the evidence that Celtic did not complete the contract, along with the fact that it failed to plead substantial performance, conclusively negated Celtic's right to judgment on a breach of contract claim.[185]

C. Substantial Completion Versus Material Breach

In *Continental Dredging, Inc. v. De-Kaizered, Inc.*,[186] the Texarkana Court of Appeals addressed questions of good and workmanlike construction, as well as the doctrine of substantial completion in the context of an allegation of material breach. De-Kaizered hired Continental Dredging to dredge to a uniform depth of thirty-six feet in front of its dock in the Houston ship channel. Continental sued De-Kaizered for payment on the contract, and De-Kaizered defended with allegations that Continental breached the agreement, breached warranties, and violated the DTPA. The jury awarded Continental contract damages for $123,556, offset by an award of $56,485 to De-Kaizered for Continental's breach of warranty. Continental appealed, arguing that the evidence was insufficient to support damages under the DTPA and the breach of warranty theory. The facts regarding the dredging performed were disputed.

The court confirmed that a mere breach of contract does not constitute a violation of the DTPA and that the evidence did not support a finding of a DTPA violation.[187] In addition, the court determined that the contract between the parties included an implied warranty of good and workmanlike construction and that Continental was required to perform its

182. *Id.* at *8.
183. *Id.* (citing Vance v. My Apartment Steak House of San Antonio, Inc., 677 S.W.2d 480, 481 (Tex. 1984)).
184. *Id.* at *9.
185. *Id.* at *10.
186. Continental Dredging, Inc. v. De-Kaizered, Inc., 120 S.W.3d 380 (Tex. App.—Texarkana 2003, pet. denied).
187. *Id.* at 389.

work in a manner generally considered proficient by one with knowledge and experience in the trade. Because the jury found that Continental breached the contract, the court found that there was evidence that Continental failed to perform in a good and workmanlike manner and, therefore, breached the implied warranty.

Finally, the court noted that De-Kaizered failed to submit a question to the jury regarding whether the breach was a material breach. The jury did find that De-Kaizered was not excused from its payment obligation. Implicitly, then, the jury found that there was no material breach, and the court determined that there was substantial performance and no discharge of De-Kaizered's payment obligation.[188]

X. CONSTRUCTION DEFECTS AND INSURANCE COVERAGE

The question of whether an alleged construction defect can ever qualify as an "occurrence" and trigger an insurer's duty to defend and/or duty to indemnify in favor of the insured in the context of a commercial liability policy continues to be a subject of discussion by the Texas courts. While the courts have struggled with such questions, the most recent decisions make it clear that the Texas state courts are reluctant to expand coverage to include damages for defective work performed by the insured contractor itself, as opposed to defective work by a subcontractor or as opposed to "resulting damage" to a third party's work.

A. THE CONTRACTOR'S DEFECTIVE WORK IS NOT AN "OCCURRENCE"

During 2003, the United States District Court for the Northern District of Texas had the opportunity to apply Texas law in a dispute over general liability insurance and its application in the context of a construction project. In *Jim Johnson Homes, Inc. v. Mid-Continent Casualty Co.*,[189] Jim Johnson Homes instituted a declaratory judgment action seeking to impose an obligation to defend upon Mid-Continent under a liability policy. The plaintiff home builder was involved in underlying litigation with homeowners who had hired Jim Johnson Homes to construct a residence. Mid-Continent defended, arguing that the claims by the homeowners did not qualify for coverage because they did not allege "property damage" caused by an "occurrence" and because exclusions relating to damage to property on which the insured was working applied.

The allegations of the homeowners included claims that the foundation and other scopes of the work were not constructed in accordance with the plans and specifications. The homeowners notified Jim Johnson Homes that it was in material breach of the contract, and Jim Johnson stopped work. The homeowners terminated the contract, but only after they no-

188. *Id.* at 394-95.

189. Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co., 244 F. Supp. 2d 706 (N.D. Tex. 2003).

ticed cracking in the foundation, which the owners' engineers opined was caused by improper foundation construction. The homeowners filed claims against Jim Johnson for breach of contract, fraud, and violations of the DTPA.[190]

The policy in question contained standard coverage language which provided that the policy would pay "sums that the insured becomes legally obligated to pay as damages because of . . . 'property damage' to which [the] insurance applies."[191] After reviewing various pleadings, the court determined that the duty to defend was ripe for adjudication and that no allegations contained in the homeowners' claims could possibly trigger coverage under the liability policy.[192] The court applied the well-accepted rules regarding the interpretation of "occurrence" and "property damage," as well as the exceptions dealing with work performed by the insured. The court referred to the recent decision in *Hatrick v. Great American Lloyds Insurance Company*,[193] discussed in last year's article, in support of its conclusions.

B. Mold and Insurance Coverage

In December 2002, the Austin Court of Appeals had the opportunity to review a trial court's award of more than $32 million in damages to a homeowner in a mold case. In *Allison v. Fire Insurance Exchange*,[194] the court reviewed the claims of Mary Ballard against Fire Insurance Exchange ("FIE"), a member of the Farmers Insurance Group. The claim originally arose as a single claim for water damage to a hardwood floor, but evolved into a mold contamination case affecting the entire structure and outbuildings. FIE argued on appeal that the evidence was legally and factually insufficient to support the jury's finding of liability. The court of appeals determined that the trial court did not abuse its discretion in the evidentiary ruling about which FIE complained.[195] The court further concluded that there was sufficient evidence to uphold the jury's finding that FIE breached its duty of good faith and fair dealing and that FIE violated the DTPA, but there was insufficient evidence to support the holding of fraud, failure to appoint a competent appraiser, and knowing violations of the duty of good faith and fair dealing.[196] The court, therefore, affirmed the actual damages award of more than $4 million, but reversed the judgment for punitive and mental anguish damages.[197]

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190. *Id.* at 709-11.

191. *Id.* at 712.

192. *Id* at 714.

193. Hatrick v. Great Am. Lloyds Ins. Co., 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.).

194. Allison v. Fire Ins. Exch., 98 S.W.3d 227 (Tex. App.—Austin 2002, pet. withdrawn).

195. *Id.* at 233.

196. *Id.* at 233-34.

197. *Id.*

The home at issue was purchased by the plaintiff in 1990 at a foreclosure sale, and FIE began to insure it in 1992. Within a couple of years before the claims at issue, which began in 1998, the home had some plumbing leaks. In 1996 and 1997, Ballard filed claims for plumbing leaks caused by frozen pipes. Plumbing leaks continued, although the next claim was not filed until 1998. Ballard continued to notice buckling and problems with the floors throughout 1998. On December 17, 1998, Ballard filed an insurance claim for the water damage to the hardwood floors. An outside adjuster opined that the damage was caused by a foundation issue and that the damages were not covered by the insurance policy. He later reconsidered and requested additional tests. The FIE adjuster estimated the claim to be around $100,000. Ballard's estimates for repairs ranged from $89,000 to $171,000.

The FIE adjuster and an engineer visited the home in January 1999, to inspect the damage. The engineer found two sources of moisture: a bathroom and around the refrigerator. The adjuster later sent a letter to Ballard noting that plumbing tests had been performed but had not located any leaks. Moisture tests continued to show high levels of moisture in the hardwood floors. Following a new appraisal of the property, FIE increased the level of coverage for the home to $750,000 and the contents to $450,000. FIE requested additional time to continue its investigation. Ballard hired an attorney.

In February 1999, FIE paid approximately $108,000 for the claim for accidental water discharge damage to the floor. In March, FIE reviewed newly discovered damage to the floors. In April, Ballard began to suspect that there might be a mold problem and had testing performed. The tests did report the presence of mold, and the family moved out of the residence. FIE paid additional damages for claims in April 1999. In May 1999, Ballard filed suit against FIE for breach of contract, deceptive trade practices, breach of the duty of good faith and fair dealing, and negligence.[198]

At trial, the jury awarded $2.5 million to replace the home, $1.1 million to remediate the home, $2 million to replace the contents of the home, $350,000 for living expenses, and $176,000 for appraisal fees, plus $5 million in mental anguish, $12 million in punitive damages, and more than $8 million in attorneys' fees.[199] FIE filed multiple issues on appeal, the most significant of which are discussed below.

On appeal, the court determined that the trial court had not erred in excluding a causation witness, because the party seeking to offer the testimony of the witness did not establish a reliable foundation for the admission of the general causation evidence.[200] The court also carefully reviewed all of the evidence presented in making its determination that there was sufficient evidence to support the finding of a breach of the

198. *Id.* at 236.
199. *Id.* at 237.
200. *Id.* at 240.

duty of good faith and fair dealing, stating that the legal standard that such a breach occurs is when the claim is denied or payment is delayed when "the insurer's liability has become reasonably clear."[201]

XI. PASS THROUGH CLAIMS

In *Interstate Contracting Corp. v. City of Dallas*,[202] the Court of Appeals for the Fifth Circuit certified to the Texas Supreme Court certain questions related to "pass through" claims. The City of Dallas entered into a contract with Interstate Contracting Corporation ("ICC") on a fixed sum basis for the construction of levees around a water treatment plant and related work. ICC entered into two subcontracts with Mine Services, Inc. ("MSI") for certain of the work. MSI was forced to manufacture material by mixing sand with limited quantities of clay to have suitable material for the work, which substantially increased the costs associated with the job. The contract was silent as to the issue of manufacturing fill material. ICC informed the city of MSI's increased work, but the city indicated it would deny any claim for additional compensation because the work performed was beyond the scope of the contract. The contract between ICC and MSI provided that ICC was given the sole discretion to bring a claim against the city on behalf of MSI at MSI's expense. ICC did file suit against the city on behalf of MSI.

The District Court for the Northern District of Texas allowed ICC to bring the claims on behalf of MSI. On appeal, the city argued that the judgment was in error, because there was a lack of privity between the subcontractor and city. ICC argued that, even though there was a lack of privity, the court correctly permitted ICC to present MSI's claims on a pass through basis. While the court of appeals found support for actions against the federal government for pass through claims, it found no Texas authority for claims against a state entity. Accordingly, the court of appeals certified to the Texas Supreme Court a question to determine "[d]oes Texas law recognize pass-through claims, i.e., may a contractor assert a claim on behalf of its subcontractor against the owner when there is no privity of contract between the subcontractor and the owner."[203]

XII. PERFORMANCE BONDS AND THE MATERIAL ALTERATION DOCTRINE

In *Cumberland Casualty & Surety Company v. Nkwazi*,[204] the Austin Court of Appeals addressed the issue of a surety's obligations under its bond, in the face of the surety's argument that it had been wholly discharged by the actions of the owner, by reason of the material alteration

201. *Id.* at 248 (citing TEX. INS. CODE ANN. art. 21.21, 4(10)(a)(11) (Vernon Supp. 2003); Universal Life Ins. Co. v. Giles, 950 S.W.2d 48, 55 (Tex. 1997)).

202. Interstate Contracting Corp. v. City of Dallas, 320 F.3d 539 (5th Cir. 2003).

203. *Id.* at 545.

204. Cumberland Cas. & Sur. Co. v. Nkwazi, No. 03-02-00270-CV, 2003 Tex. App. LEXIS 4902, at *1 (Tex. App.—Austin June 12, 2003, no pet.) (mem. op.).

doctrine. The underlying facts of the case involved a company called Nkwazi, which hired Salinas Construction to build a Comfort Inn motel. Comfort Inn gave Nkwazi guidelines for the motel's construction, and Nkwazi hired an architect who drafted drawings to be used for the bid process and construction. In 1997, Nkwazi sent out the plans for bidding and later accepted the bid submitted by Salinas. Nkwazi and Salinas signed a two-page proposal, which Nkwazi maintained was the only contract between the parties. Nkwazi's lender required the project to be bonded, so Cumberland issued a performance bond for Salinas's work on the project.

After repeated problems between Nkwazi and Salinas, Nkwazi declared Salinas in default and made a demand upon the performance bond. Cumberland refused coverage, and Nkwazi filed suit against Cumberland. After a jury trial, the court granted judgment in favor of Nkwazi for damages and attorneys' fees. Cumberland appealed, arguing that the jury's findings were against the great weight of evidence.[205]

Cumberland did not dispute in the case that it did not perform under the bond in question. Rather, Cumberland argued that its obligations under the bond were completely discharged as a result of Nkwazi's material alteration of the bonded contract. The material alteration which Cumberland pled was that Nkwazi failed to hire an architect to inspect Salinas' work, which led to substantial overpayment for faulty work which was performed. Cumberland argued that proper payment to Salinas under the contract was a condition precedent to its obligations under the bond.

Questions 2 and 3 submitted to the jury in the case both asked whether Cumberland's non-performance was excused by Nkwazi's failure to satisfy conditions precedent. The bond itself, which followed Form A312 of the American Institute of Architects' forms, set forth the requirements for bond performance. In particular, the bond required that there be no "Owner Default." If no default occurred, the bond provided that the surety's obligations to perform would arise. Paragraph 12.4 of the contract in question provided that "Owner Default" would include "[failure] of the Owner, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof."[206]

Nkwazi argued that it was not in default because the contract did not specifically require an architect to be hired to inspect the construction, and further, that the only contract in existence was the bid proposal by Salinas, not a longer form contract as required by the bid. Cumberland responded that the bid proposal required the parties to execute an AIA standard form contract, and that Nkwazi should be held to the AIA provision which required an architect to be employed.

The Austin court noted that it could reverse only if the jury's answers

205. *Id.* at *1-2.
206. *Id.* at *3-4.

were against the great weight of the evidence.[207] In reviewing the evidence, the court noted that construction began in April 1997, and that Nkwazi paid Salinas progress payments. Salinas failed to follow the construction plans and defects became apparent as the work progressed. Salinas remedied some but not all of the problems. Nkwazi admitted that it did not have an architect inspect the progress of the construction during the work, but the testimony also indicated that Nkwazi did not know of any such requirement to hire an architect for that purpose. Even after various meetings and plans to remedy problems, Salinas continued to experience difficulties in performing the requirements of the contract.

The court found, based upon the evidence in the record, that there was sufficient evidence to support the jury's verdict.[208] The court noted that there was conflicting evidence in the record regarding the proposal, as well as the contents of the contract. While the bid anticipated that the parties would sign an AIA contract, the owners testified that there was no separate contract and that they were not aware that a separate contract was required. Cumberland's file contained the proposal, but no AIA contract form. Based upon all of that evidence, the court concluded that the jury's verdict was not manifestly unjust.[209] The court found that Cumberland issued the bond without requiring the parties to sign an AIA contract. Because there was no AIA contract, the court held that Cumberland's position that there had been a material alteration of the AIA contract could not be sustained. The court refused to apply the material alteration as a result of overpayment rule stated in *Old Colony Insurance Co. v. City of Quitman*.[210]

XIII. LEGISLATIVE DEVELOPMENTS

A. The Property Code

One change to the Texas Property Code and its provisions in Chapter 53 pertaining to liens instituted in 2003 was the addition of the provision which permits a person who furnishes labor or materials for the demolition of a structure on real property by a written contract with the owner or the owner's agent a mechanic's lien on the property.[211]

B. Legislation Impacting Residential Construction

The legislation affecting residential construction which took effect in 2003 included changes to the Texas Property Code and the RCLA. First, the legislature enacted the Texas Residential Construction Commission Act, which created the Texas Residential Construction Commission, state sponsored inspection and dispute resolution, and warranties and building

207. *Id.* at *6.
208. *Id.* at *9-10.
209. *Id.* at *12.
210. Old Colony Ins. Co. v. City of Quitman, 163 Tex. 144, 352 S.W.2d 452 (1961).
211. Tex. Prop. Code Ann. § 53.021(e) (Vernon Supp. 2003).

performance standards. That legislation is now Title 16 to the Texas Property Code. In addition, the legislature amended certain provisions to the RCLA, including the definitions section[212] and various sections pertaining to relief which is available under the Act.[213]

212. TEX. PROP. CODE ANN. § 27.001 (Vernon Supp. 2003).
213. *Id.* at §§ 27.003, 27.004.